

STATE TEACHERS' RETIRMENT SYSTEM

INVESTMENT COMMITTEE

SUBJECT: Equity - RFP for International
(Non-U.S.) Equity

ITEM NUMBER: 5

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: August 5, 1998

INFORMATION: _____

PRESENTER(S): Ms. Okada

BACKGROUND

At the May 1998 Investment Committee meeting, a presentation was made on the role of non-U.S. equity including the role of active management for the international portfolios. The following recommendations were approved by the Committee:

1. The MSCI EAFE Index should continue to be the benchmark for STRS' non-U.S. equity portfolio. This includes indices for regional mandates.
2. Modify the strategic allocation target to 50% active management and 50% passive management for the non-U.S. equity portfolio. The strategic allocation target would have a range of 45% to 55%.
3. The actively managed allocation should consist of EAFE and regional (European and Pacific Basin) mandates. The strategic allocation target for the regional mandates should be the EAFE weightings with a range of +/- 5% for each region.

One of the objectives approved by the Investment Committee in July was to structure a Request For Proposal (RFP) that will implement the active components of the above decisions. The structure of this RFP will incorporate the recommendations made by the Cortex Group which the Board adopted in concept at the July Board meeting.

Attachment 1 provides detailed information for the RFP that includes:

- ⇒ Time line for the RFP
- ⇒ Introduction
- ⇒ Purpose of the RFP
- ⇒ Services to be Provided
- ⇒ Minimum Qualifications

- ⇒ Fee Structure
- ⇒ Proposal Evaluation Criteria

Staff is proposing that the contract participation goal requirement for Disabled Veterans Business Enterprise be required after the final selection process is completed. Upon submission of proposals to STRS, all proposers shall execute a certification, included as Attachment 2, confirming their intent to submit the necessary documentation to STRS in the event they are selected. Each manager shall be required to submit documentation substantiating compliance with the goal prior to the final execution of their contract.

RECOMMENDATION

In concert with the Cortex recommendations and paralleling the process for the Domestic Equity Managers search, Staff recommends that the Investment Committee approve the following:

1. The release of the Request for Proposal as described in Attachment 2;
2. Use of a “Manager Pool” of qualified active managers to replace terminated managers or to supplement the roster of contracted managers;
3. Use of opened ended contracts (Evergreen contracts), and ;
4. Delegation of the “Final Selection” to staff and PCA.

STATE TEACHERS' RETIREMENT SYSTEM
NON-U.S. EQUITY MANAGER(S)

TIME SCHEDULE:

Date of Issue:	<u>September 1998</u>
Deadline for Submission of Written Questions:	<u>September 1998</u>
Final Filing Date:	<u>November 1998 @ 4:30 p.m.</u>
Pre-evaluation Screening:	<u>November 1998</u>
Proposal Evaluation:	<u>November 1998 - January 1999</u>
Interviews:	<u>January 1999</u>
Submission of Contract Partici- pation Goal Documentation:	<u>To be Announced</u>
Reference Checks:	<u>To be Announced</u>
On-Site (Optional):	<u>To be Announced</u>
Post Notice of Intent to Award:	<u>Immediately After Selection</u>
Award of Contract:	<u>5 business days after posting notice of intent to award</u>

STATE TEACHERS' RETIREMENT SYSTEM
REQUEST FOR PROPOSAL

NON-U.S. EQUITY MANAGER(S)

I. INTRODUCTION

The California State Teachers' Retirement System (STRS) administers an investment portfolio with approximately \$88.3 billion in total assets. As of June 30, 1998, the assets were invested as follows: \$36.0 billion in domestic equities; \$18.5 billion in non-U.S. equities; \$2.6 billion in global TAA; \$26.0 billion in domestic fixed income securities; \$2.1 billion in real estate equity; \$2.0 in alternative investments; and \$1.1 billion in cash reserves. The Investment Management Plan adopted by the Teacher's Retirement Board (Board) provides an investment structure designed to provide diversification within each component of the portfolio. The non-U.S. equity structure contains passive and active components. The active component includes EAFE and regional mandates. STRS is in the process of soliciting proposals from firms that have expertise in active management of non-U.S. equity portfolios.

STRS intends to award contracts to a maximum of sixteen (16) Investment Management Firms within the categories identified in Section III(B). Only "live" strategies are acceptable, i.e., simulated portfolios are not allowed. STRS reserves the right to determine the number of contracts which will be awarded in any investment category, as well as the amount of each allocation. In the event that none of the proposals are satisfactory, then no selection will be made in that category. Prospective contractors may submit proposals for a maximum of two (2) of the investment mandates. If more than one mandate is proposed, each mandate must be submitted in a separate proposal under separate cover. Upon award of a contract(s), STRS shall develop investment objectives for each specific manager.

II. PURPOSE

Pursuant to Education Code 22353, STRS is seeking qualified firms to provide investment management services for non-U.S. equity investments. STRS defines non-U.S. equity management as portfolios invested in securities included in a broadly recognized index of international equities, i.e., Morgan Stanley Capital International (MSCI) EAFE. The firms selected will be fiduciaries of STRS and have discretionary authority with respect to STRS' assets.

STRS will also establish a “pool” of qualified managers from this process. This pool would be used to replace managers that might be terminated in the future or to add a manager(s) as necessary. Contracts will be executed prior to funding.

III. SERVICES TO BE PROVIDED

A. Contractor will manage, acquire and dispose of the assets of the Portfolio in accordance with STRS’ Investment Resolution. Except as otherwise provided in the manager’s contract, the manager will have full discretion over the Portfolio.

B. Contractor will manage a portfolio using one of the following investment categories:

1. Active Non-U.S. Equity Manager(s)

These managers will have full discretion over country and stock selection within the MSCI EAFE Index. Approved investments will be described in the investment guidelines and objectives which STRS shall prepare for each manager. The benchmark for evaluating this category will be the MSCI EAFE Index.

2. Active Non-U.S. Regional Equity - Europe Manager(s)

These managers will have full discretion over county and stock selection within the European region as defined by the MSCI EAFE Index. Approved investments will be described in the investment guidelines and objectives which STRS shall prepare for each manager. The benchmark for evaluating this category will be the MSCI EAFE Regional Index.

3. Active Non-U.S. Regional Equity - Pacific Basin Manager(s)

These managers will have full discretion over county and stock selection within the Pacific Basin region as defined by the MSCI EAFE Index. Approved investments will be described in the investment guidelines and objectives which STRS shall prepare for each manager. The benchmark for evaluating this category will be the MSCI EAFE Regional Index.

C. Contractor will secure and vote all proxies, tender offers, mergers, recapitalizations, and any other corporate actions on non-U.S. securities on behalf of STRS. Such corporate actions are to be voted in accordance with the Statement of Investment Responsibility and the Financial Responsibility Criteria for Corporate Investments, which may be amended from time to time. Contractor will keep and maintain a record of how all corporate actions are executed and will provide STRS with a detailed written report to be furnished on a quarterly basis. This report will identify the

company, the number of shares STRS held in the company, the issue, and the action taken.

- D. Contractor will adhere to the Board's Statement of Investment Guidelines, Objectives and Performance Criteria, which will be developed by STRS specifically for each manager chosen and will be incorporated by reference into the contract(s).
- E. Contractor will provide advice to the Board and STRS staff on market conditions, including positive and/or negative trends, and various security-related issues, such as corporate actions.
- F. Contractor will provide reports to the Board, STRS staff, and consultants as required by STRS.
- G. Contractor will attend Investment Committee, Board and/or staff meetings in California as requested by STRS.

IV. MINIMUM QUALIFICATIONS

The proposer must meet all of the following minimum qualifications to be given further consideration. Failure to satisfy each of the minimum qualifications will result in immediate rejection of the proposal.

- A. If required under the Investment Advisors Act of 1940, the firm must be registered as an investment advisor, bank, insurance company, or a trust company.
- B. As of June 30, 1998, the firm must have been in business at least one year.
- C. As of June 30, 1998, the firm must have a minimum of \$100 million in assets under management, of which at least \$25 million is in the discipline of active international equities.
- D. The portfolio manager(s) assigned to the STRS account must each have a minimum of 5 years of non-U.S. equity portfolio management experience.
- E. As of June 30, 1998, the firm must have at least one tax-exempt account under management.

STATE TEACHERS' RETIREMENT SYSTEM
NON-U.S. EQUITY MANAGER(S)

FEE SCHEDULE

Name of Proposer

Proposers must submit their annual flat fee schedule for active equity management for the proposed investment style in the format prescribed below. The proposed flat fee shall include all costs for providing investment services to STRS as described in this RFP. The fee earned by the manager will be paid from the portfolio (i.e., deducted from the portfolio). The allocation to each manager shall be determined by STRS.

While there is no maximum fee established, the Proposer is reminded that Fees represent 25% of the evaluation process. The proposed fee will be evaluated using a sample portfolio of \$200 million.

Once the Contractor is selected, the fee may be further refined depending on factors which may affect the proposed fee. In no case will the refined fee be higher than the fee contained in this proposal.

SECTION I - ANNUAL FLAT FEE BASED ON MARKET VALUE OF PORTFOLIO

<u>Market Value of Portfolio</u>	<u>Proposer's Annual Flat Fee In Basis Points</u>
First \$100 Million	_____
Next \$100 Million	_____
Next \$100 Million	_____
Next \$100 Million	_____
Next \$100 Million	_____
Over \$500 Million	_____

Proposer's Authorized Signature

Date

SECTION II - PERFORMANCE BASED FEE SCHEDULE

STRS reserves the right to compensate the successful proposer(s) using a performance based fee as stipulated below.

For annualized performance, the performance fee shall be calculated as set forth below.

1. Performance Fee (PF):

$$\begin{aligned} PF_1 &= (NF-BF)/RER \times (RP_1 - RM_1) \\ PF_3 &= (NF-BF)/RER \times (RP_3 - RM_3) \end{aligned}$$

Where:

PF ₁	=	Performance Fee for the Past One Year
PF ₃	=	Performance Fee for the Past Three Years
NF	=	Normal Fee = Flat Fee as stated in Section I
BF	=	Base Fee = one-third ($\frac{1}{3}$) of the Normal Fee
RER	=	Required excess return required to receive the normal fee is 150 bp
RP	=	Return of the Portfolio
RM	=	Return for the Style Benchmark

A. The total fee is calculated as follows:

$$\text{Total Fee} = \frac{1}{3} (PF_1) + \frac{2}{3} (PF_3) + BF$$

B. The minimum fee that will be paid is equal to the Base Fee (i.e., no performance fee was earned).

C. The Contractor will earn a performance fee when the return of the portfolio exceeds the return of the market.

Relating this to the performance fee formula above, the right hand portion, "(RP-RM)", must be positive to earn a performance fee. When this term is zero or negative, no performance fee is earned and the total fee is simply equal to the Base Fee.

D. The maximum fee is earned by the Contractor when the annualized performance, exceeds the benchmark by 300 basis points. The maximum fee that can be earned is calculated as follows:

$$\text{Maximum Fee} = 2 (NF-BF) + BF$$

III. The mechanics of the fee schedule is as follows:

- A. If the inception date does not coincide with the beginning of a Calendar Quarter, then the manager will be compensated using the Flat Fee (as specified in Section I) until the beginning of the next Calendar Quarter.
 - B. For each of the first three calendar quarters, the Contractor will receive a fee equal to one fourth the Base Fee. The assets under management will be the average of the market value of all months during the performance period.
 - C. At the end of the fourth quarter an annual fee will be calculated to determine if a Performance Fee has been earned by the Contractor. This fee will be applied to the assets under management to determine the dollar amount to be paid. The assets under management will be the average of the market value of all months during the performance period
 - D. For quarters 5 through 12, the annualized performance fee will be calculated each quarter on a cumulative annualized basis. Any performance fee due the Contractor will be applied to the assets under management to determine the dollar amount to be paid. The assets under management will be the average of the market value of all months during the performance period.
 - E. After three years, the performance fee will be calculated each quarter on a cumulative annualized basis covering a rolling twelve quarter period. Any performance fee due the Contractor will be applied to the assets under management to determine the dollar amount to be paid. The assets under management will be the average of the market value of all months during the performance period
 - F. Market values, portfolio return, and the return for the market index will be provided to STRS by the Board's Master Custodian.
- IV. In the event that STRS assigns additional assets to the Portfolio, such assets will be will be prorated on a daily basis to calculate an accurate month-end market value.
- V. If the Contractor ceases to manage funds under the contract in the middle of a calendar quarter, the base fee will be used for compensation. The fee will be prorated to cover the Contractor's services through the date of termination.

NON-U.S. EQUITY MANAGER(S)
WRITTEN PROPOSAL EVALUATION SHEET

Name of Proposer

____ EAFE ____ Regional - European ____ Regional - Pacific Basin

MAXIMUM PROPOSER'S
POINT POINT
SCORE SCORE

A. PROPOSAL QUESTIONNAIRE

Section I

Organizational Background

Professional Staff

Assets and Accounts Under Management

Subtotal 30

Section II

Investment Philosophy

Decision-Making Process

Portfolio Management Process

Research

Trading

Client Servicing

Subtotal 65

Total Sections I & II* 95

Section III

Performance 40

Total Item A 135

B. FEES 90

C. INTERVIEW** 135

D. ON-SITE pass/fail

GRAND TOTAL 360

* A proposer must receive a combined score of at least 66 points on Sections I and II to be given further consideration.

** A proposer must receive a minimum score of 95 points on the Interview to be given further consideration.

Rater No. _____

Date _____

CERTIFICATION TO COMPLY WITH
DISABLED VETERAN BUSINESS ENTERPRISE
CONTRACT PARTICIPATION REQUIREMENT

I/We have agree to comply with the Contract Participation Goal requirements. It is understood and agreed that, should our firm be selected as a successful Proposer for this process, the required documentation shall be completed and submitted to STRS to substantiate compliance with the requirements. Documentation shall be submitted prior to the posting of the Notice of Intent to Award, on a date specified by STRS, and shall be subject to STRS' review and approval. We further understand that if this documentation is insufficient and cannot be corrected prior to the date specified by STRS, an agreement cannot be executed..

Proposer's Authorized Signature

Title

Company Name of Proposer

Date